97TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 97-827

# NORMALIZATION METHOD FOR PUBLIC UTILITY PROPERTY

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SEPTEMBER 16, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

## REPORT

[To accompany H.R. 1524]

[Including the cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 1524) to amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 with respect to the treatment of public utility property, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments (stated in terms of the page and line numbers of the introduced bill) are as follows:

On the first page, strike out line 5 and all that follows down through line 3 on page 3, and insert:

> (a) GENERAL RULE.—Paragraph (3) of section 168(e) of the Internal Revenue Code of 1954 (relating to special rule for certain public utility property) is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph (B) the following new subparagraph:
>
> "(C) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC.—
>
> "(i) IN GENERAL.—One way in which the requirements of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).
>
> "(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure

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or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (B)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

"(iii) REGULATORY AUTHORITY.—The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i)."

(b) AMENDMENT TO SECTION 167(l).—Subparagraph (G) of section 167(l)(3) of such Code (defining normalization method of accounting) is amended by adding at the end thereof the following new sentence:

"For purposes of this subparagraph, rules similar to the rules of section 168(e)(3)(C) shall apply."

Page 6, strike out lines 10 through 13.

Amend the title of the bill so as to read:

A bill to amend the Internal Revenue Code of 1954 to provide that certain procedures and adjustments shall be treated as inconsistent with the normalization method of treating public utility property.

## I. SUMMARY

For property placed in service after 1980, public utilities generally are allowed the investment credit and accelerated cost recovery only if the benefits of the investment credit and accelerated cost recovery are normalized for ratemaking purposes. For property placed in service before 1981, similar rules apply to investment credits and accelerated depreciation, but certain companies are exempted from the normalization requirement. Normalization generally requires that tax benefits be taken into account for ratemaking purposes over the service life of the asset that generates the tax benefits.

Subject to certain exceptions for grandfathered companies, normalization rules for accelerated depreciation were imposed in 1969. Subject to the same general grandfather exceptions, normalization rules for the investment credit were imposed in 1971. Except as provided in certain transition rules, the normalization rules were made mandatory and more comprehensive for property placed in service after 1980.

The bill would restate and make more specific the normalization rules relating to the investment credit (sec. 46(f)), accelerated depreciation (sec. 167(l)), and accelerated cost recovery (sec. 168(e)(3)). The bill would also give the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking projections and adjustments are inconsistent with the normalization rules. The amendments generally would apply to taxable years beginning after December 31, 1979.

The bill would also provide a special transition rule. Under the special rule a ratemaking projection or adjustment that violated the normalization requirements would not result in a public utility's loss of eligibility for the investment credit or accelerated depreciation if the projection or adjustment (1) applied for a period ending before March 1, 1980, (2) was included in an order entered by a public service or public utility commission before March 13, 1980, and (3) was used to determine the amounts of rates which were ordered to be collected or refunds which were ordered to be made.

The special transition rule is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of American Telephone and Telegraph), General Telephone Company of California (a subsidiary of General Telephone & Electronics Corporation), and Southenr California Gas Company.

## II. EXPLANATION OF THE BILL

### A. Present Law

***In general***

Generally, utility regulatory commissions allow a utility to charge customers so that the utility can collect enough revenues to cover its cost of service. The cost of service includes annual operating expenses and annual capital expenses. Operating expenses include expenses such as labor, fuel, State and local taxes, and Federal income taxes. Capital expenses include an annual depreciation charge for operating assets and a rate of return on the utility's rate base (the basis of its operating assets).

Accelerated depreciation methods, accelerated cost recovery, and investment credits were enacted to encourage higher rates of investment in new and replacement property. By reducing the initial cost of equipment or permitting a more rapid recovery of capital, these investment incentives increase the estimated after-tax rate of return from the asset.

For investments in public utility property, there are two general ways a utility regulatory commission can account for the benefits of accelerated depreciation, accelerated cost recovery, and investment credits in setting utility rates. One way, flow-through accounting, treats these benefits as a current reduction in Federal income tax expense. Thus, current operating expenses are reduced and the benefit is flowed through to the current utility customers. A second way, normalization accounting, treats these benefits as a reduction in capital expenses. As a reduction in capital expense, the benefits are still flowed through to customers. However, because the benefits are flowed through as reduced depreciation charges or returns on reduced rate base, they are flowed through to customers over the service life of the through as reduced depreciation charges or returns on a reduced rate asset that generated the tax benefit or the period for which tax is deferred. Thus, under normalization accounting, the benefit of reduced capital expenses for a specific capital investment is enjoyed by all the utility customers who pay the capital expenses of the investment.

***Accelerated depreciation and accelerated cost recovery***

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the ratemaking treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a current reduction in cost of service and therefore flowed it through to customers currently as lower rates. This practice, which is known as "flow-through" ratemaking, meant that

accelerated depreciation would provide no investment incentive except to the extent that lower rates increased consumer demand and created thet need for additional capacity.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), a utility which had not previously used accelerated depreciation for Federal tax purposes could thereafter use accelerated depreciation only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[1]

Code section 167(l)(3)(G) provides that:

> "In order to use a normalization method of accounting with respect to any public utility property—
>
> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
>
> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)–1(h)) interpret this section defining normalization to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of the cost of service. The Treasury Regulations (§ 1.167(a)–11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, some or all of the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the benefits of the tax deferrals from accelerated depreciation being reflected in the rates charged to customers as a reduction in capital expenses over the period of tax deferral.

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[1] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply means the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;
(2) Gas or steam through a local distribution system;
(3) Telephone services;
(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or
(5) Transportation of gas or steam by pipeline, if the rates, for the furnishing or sale, are established or approved by certain regulatory bodies.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: first, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury and, second, to avoid the additional loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce utility profits.

When Congress enacted the accelerated cost recovery system (ACRS) in the Economic Recovery Tax Act of 1981 (ERTA), it decided that the full benefits of ACRS should be normalized by all public utilities. Therefore, except as provided in a special transition rule for rate orders issued before enactment of ERTA, all public utilities are required to normalize the tax benefits of ACRS accelerated depreciation, shortened useful lives, salvage value rules, and placed-in-service averaging conventions.

***Investment tax credit***

When Congress restored the investment tax credit in 1971, it provided that the investment tax credit for public utility property generally would not be available if the credit was flowed through to utility customers at a rate faster than that permitted under one of two optional normalization rules. However, utilities permitted to use flow-through accounting for the benefits of accelerated depreciation under the grandfather rules of the Tax Reform Act of 1969 were also permitted to use flow-through accounting for the investment tax credit if they made an affirmative election. In the Revenue Act of 1975, Congress increased the amount of the credit for public utility property that could be used to offset tax liability and increased the amount of the credit for public utility property from 4 percent to 10 percent. For this additional credit, flow-through accounting was not permitted to the grandfathered utilities unless the utility made a new affirmative election.

When Congress revised the investment tax credit provisions in the Economic Recovery Tax Act of 1981, it generally repealed the flow-through exception for all property placed in service after 1980. Thus, except as provided in a transition rule for rate orders issued before enactment of ERTA, all public utilities must use one of two normalization methods to account for investment credits for public utility property placed in service after 1980.

The two optional normalization rules of section 46(f) are known as the rate base reduction rule and the ratable flow-through rule. Both of these normalization rules permit some of the benefit of the investment tax credit to be flowed-through to utility customers as a reduction in capital expense. Taxpayers generally are subject to the rate base reduction rule unless they made an election in 1972 to be subject to the ratable flow-through rule or, if eligible, made an election to use flow-through accounting. For a limited group of utilities, gas pipeline companies, a special election also was available in 1972 that prohibited any flow-through of the credit, either as a reduction in current operating expense or a reduction in capital expense over the service life of the qualifying property.

Under the rate base reduction rule, some of the benefits of the investment tax credit may be flowed through to utility customers as a reduction in capital expense by excluding the credit from the utility's rate

base. In this way, the utility customers are not required to pay a rate of return to the utility on the part of the cost of equipment that was paid for, in effect, by the investment tax credit. However, under this rule, no other adjustment may be made to the operating expenses or capital expenses included in the utility's cost of service. Thus, no adjustment is permitted to be made, by reason of the credit, to the utility's Federal income tax expense or depreciation allowance included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a depreciation allowance for the part of the equipment cost paid for, in effect, by the investment credit.

Under the ratable flow-through rule, the benefits of the investment tax credit may be shared with utility customers by denying any depreciation allowance in the utility's cost of service for the part of the equipment cost that was paid for, in effect, by the investment credit. Under this rule, no additional adjustment may be made by reason of the credit to the utility's operating expenses or capital expenses included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a rate of return on the part of equipment cost paid for, in effect, by the investment credit.

***Projections, estimates, and adjustments***

The application of the depreciation and investment tax credit normalization rules has generated considerable controversy and uncertainty, due in part to the nature of the ratemaking process. In setting utility rates, it is customary to use a "test period" as a surrogate for the period when utility rates will actually be collected. Based on the experience of the test period (investment levels, operating expenses, etc.) appropriate rates are established. In some jurisdictions, adjustments are made to the test period experience to reflect expected changes in the future relationships between investments, expenses, and revenues. An example of such an adjustment would be a change in the Federal income tax rate to take effect after the close of the test period.

The proper application of the normalization rules with respect to the use of adjustments, estimates, and projections has been especially controversial in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected and flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requir-

ing that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including three more decisions of the California Supreme Court and two unsuccessful petitions for certiorari to the U.S. Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers.

The Internal Revenue Service has issued private letter rulings that take the position that these methods do not comply with the normalization requirements. The IRS has asserted deficiencies for some of the taxable years in issue. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment tax credit even though the allowance of these benefits has already been reflected in reduced rates or refunds to utility customers. Another California utility (Southern California Gas Company) apparently has a similar problem relating to the manner in which the investment tax credit may be taken into account in establishing a utility's rate of return.

It is understood that the California Public Utility Commission has not required the use of these controversial accounting methods for any period after March 1, 1980.

### B. Reasons for Change

Considerable controversy has arisen over the proper application of the normalization rules, principally in California. After protracted deliberations and litigation during the 1970's, the California Public Utilities Commission entered an order requiring the Pacific Telephone and Telegraph Company and General Telephone Company of California to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers. Although no final determination has been made as to whether these methods comply with the Code's normalization requirements, the Internal Revenue Service has issued private rulings which take the position that the methods do not comply with such requirements. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which cannot be flowed through by utilities which are otherwise grandfathered on a flow-through method.

The committee believes that it is desirable to clarify for the future the rules relating to normalization so that no further disputes of the type which has occurred in California will arise. The committee also believes that it is appropriate to provide a special rule that would

exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used accounting methods which were prescribed by an order of a public utility commission entered prior to March 13, 1980. This special rule is designed to meet a specific, one-time problem which has arisen as a result of a misapplication of the normalization rules in certain California cases. The committee does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief should subsequent incidents of a similar nature occur.

## C. Explanation of Provisions

The bill contains two amendments to the normalization rules which do not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, and designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of American Telephone and Telegraph), General Telephone Company of California (a subsidiary of General Telephone & Electronics Corporation), and Southern California Gas Company.

### *Accelerated depreciation and accelerated cost recovery*

The bill would add a new provision which clarifies the present definition of the normalization method of accounting under the accelerated cost recovery system and for accelerated depreciation purposes in a manner which generally follows the interpretation now contained in Treasury regulations relating to accelerated depreciation.

This added provision generally provides that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury would also be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "Average Annual Adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the normalization requirements.

The new Code provision to be added by the bill specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for accelerated depreciation.

### *Investment tax credit*

The bill would add a new provision to the rules relating to normalization of the investment tax credit. The new provision generally provides that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment

tax credit unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The Treasury Department would also be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method or the ratable flow-through method. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "Annual Adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provision to be aded by the bill specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for the investment tax credit.

***Special rule for periods prior to March 1, 1980***

The bill would provide that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections, or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order. For purposes of this special rule, a qualified order is an order of a public utility commission—(1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule would apply to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

## D. Effective Date

The provisions of the bill (other than the special rule) generally would apply to taxable years beginning after December 31, 1979. However, these provisions can be overridden by the special rule for periods prior to March 1, 1980.

The bill explicitly provides that, in applying the normalization rules (Code secs. 46(f) and 167(l)(3)) to taxable years beginning before January 1, 1980, no inference shall be drawn from the amendments to these rules or from the special rule. However, this no inference rule is not intended to limit the relief provided by the special rule.

## III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

### *Budget Effects*

In compliance with clause 7(a) of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of H.R. 1524, as reported.

The permanent changes made by the bill would have no revenue effect, assuming that rate orders in effect for periods ending after March 1, 1980, are in compliance with the normalization rules as to be revised by the bill.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980, to the three utilities which would be benefitted by the special rule do not comply with the current normalization rules in the Code, the special rule in the bill would result in a revenue loss of approximately $2,200 million attributable to accounting periods prior to March 1, 1980. Approximately $117 million of this amount has been paid to the Treasury and would be the subject of claim for a refund. If the transitional rule is enacted, such amount would probably be repaid during fiscal year 1983. The remainder of the $2,200 million revenue loss generally would occur in the fiscal years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1987 because of the timing of the audit process and delays of presumed litigation.

If these orders do comply with the current normalization rules, the special rule in the bill would result in no revenue loss.

The Treasury Department agrees with this statement.

### *Vote of the Committee*

In compliance with clause 3(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill. The bill, H.R. 1524, as amended, was ordered favorably reported by voice vote.

## IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 2(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 1524, as amended.

### *Oversight Findings*

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to the normalization rules relating to the investment tax credit and accelerated depreciation for public utilities that the committee concluded that it is appropriate to enact the provisions contained in the bill. The bill was the subject of hearings by the committee on June 21, 1982.

### *New Budget Authority and Tax Expenditures*

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new tax expenditures.

To the extent that the special rule overrides denial of the investment tax credit and accelerated depreciation (under present law) in cases where the normalization rules, or alternative requirements, in Code sections 46(f) and 167(l) are applicable, the special rule temporarily and retroactively expands existing tax expenditures applicable to fiscal years prior to 1981. However, if the qualified orders of the California Public Utilities Commission applicable prior to March 1, 1980, result in continued eligibility for accelerated depreciation and the investment tax credit by the utilities affected by this bill, there would be no effect upon tax expenditures.

### *Consultation with Congressional Budget Office on Budget Estimates*

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part III of this report) and has submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
*Washington, D.C.*

Hon. DAN ROSTENKOWSKI,
*Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: In accordance with the Budget Act, the Congressional Budget Office has examined H.R. 1524, Normalization Requirements for Public Utility Property and Special Transition Rule. This bill would amend the Internal Revenue Code of 1954 relating to

the normalization of the investment tax credit and accelerated depreciation of public utility property. The special transition rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

This bill does not provide for any new budget authority or any new or increased tax expenditures.

In accordance with Section 403 of the Budget Act, the Congressional Budget Office estimates that if H.R. 1524 is enacted, $117 million in revenues already paid to the Treasury would be subject to a claim for a refund which could be filed during fiscal year 1983. If this claim is successful, the $117 million would be returned to the utilities, and current law revenues would be reduced by this amount. For scorekeeping purposes, CBO has assumed that, if this bill passes, current law revenues will be reduced by $117 million in fiscal year 1983.

In addition, the effect of the special rule is that approximately $2.1 billion in uncollected revenue due because of past ineligibility for the investment tax credit and accelerated depreciation that might otherwise be collected, would not be collected. In that event, current law revenues would be reduced by that amount in the years in which the determinations of tax liability for the affected companies would otherwise become final. Because of the timing of the audit process and the delays in presumed litigation, however, such a revenue loss would probably occur in fiscal years after 1987.

Sincerely,

RAYMOND C. SCHEPPACH
(For Alice M. Rivlin, Director).

### *Oversight by Committee on Government Operations*

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

### *Inflationary Impact*

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

## V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of Rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman) :

### INTERNAL REVENUE CODE OF 1954

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### Subtitle A—Income Taxes

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### CHAPTER 1—NORMAL TAXES AND SURTAXES

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### Subchapter A—Determination of Tax Liability

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### PART IV—CREDITS AGAINST TAX

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### Subpart B—Rules for Computing Credit for Investment in Certain Depreciable Property

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**SEC. 46. AMOUNT OF CREDIT.**

(a) GENERAL RULE. * * *

* * * * * * *

(f) LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—
(1) GENERAL RULE.— * * *

* * * * * * *

*(10) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC., FOR PURPOSES OF PARAGRAPHS (1) AND (2).—*

*(A) IN GENERAL.—One way in which the requirements of paragraph (1) or (2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of paragraph (1) or paragraph (2), as the case may be.*

*(B) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of subparagraph (A) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit allowable by section 38 unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.*

*(C) REGULATORY AUTHORITY.—The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in subparagraph (B)) which are to be treated as inconsistent for purposes of subparagraph (A).*

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## Subchapter B—Computation of Taxable Income

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## PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

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**SEC. 167. DEPRECIATION.**

(a) GENERAL RULE.— * * *

* * * * * * *

(l) REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

(1) PRE-1970 PUBLIC UTILITY PROPERTY.—* * *

* * * * * * *

(3) DEFINITIONS.—For purposes of this subsection—

(A) PUBLIC UTILITY PROPERTY.— * * *

* * * * * * *

(G) NORMALIZATION METHOD OF ACCOUNTING.—In order to use a normalization method of accounting with respect to any public property--

(i) the taxpayer must use the same method of depreciation to compute both its tax expenses and its depreciа-

tion expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

*For purposes of this subparagraph, rules similar to the rules of section 168(e)(3)(C) shall apply.*

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**SEC. 168. ACCELERATED COST RECOVERY SYSTEM.**

(a) ALLOWANCE OF DEDUCTION.— * * *

* * * * * * *

(e) PROPERTY EXCLUDED FROM APPLICATION OF SECTION.—For purposes of this section—

(1) PROPERTY PLACED IN SERVICE BEFORE JANUARY 1, 1981.— * * *

* * * * * * *

(3) SPECIAL RULE FOR CERTAIN PUBLIC UTILITY PROPERTY.—

(A) IN GENERAL.—The term "recovery property" does not include public utility property (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) USE OF NORMALIZATION METHOD DEFINED.—For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167 (l)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(C) *USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC.*—

(i) *IN GENERAL.—One way in which the requirements*

*of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).*

*(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (B)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.*

*(iii) REGULATORY AUTHORITY.—The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).*

[(C)] *(D)* PUBLIC UTILITY PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of public utility property which, by reason of this paragraph, is not treated as recovery property, the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (B)(i).

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97TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 97-828

# MODIFICATION OF THE NORTH AMERICAN CONVENTION TAX RULES

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SEPTEMBER 16, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

## REPORT

[To accompany H.R. 3191]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 3191) to amend the Internal Revenue Code of 1954 to exempt conventions, et cetera, held on cruise ships documented under the laws of the United States from certain rules relating to foreign conventions, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

That (a) paragraph (2) of section 274(h) of the Internal Revenue Code of 1954 (relating to attendance at conventions, etc.) is amended to read as follows:

"(2) CONVENTIONS ON CRUISE SHIPS.—In the case of any individual who attends a convention, seminar, or other meeting which is held on any cruise ship, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting unless—

"(A) the cruise ship is a vessel documented under the laws of the United States,

"(B) all ports of call of the cruise are inside the North American area, and

"(C) the taxpayer establishes (by written statements signed by the taxpayer and by an officer of the sponsoring organization or group, and by such other methods as may be prescribed by regulations) that the meeting is directly related to the active conduct of his trade or business or to an activity described in section 212.

Paragraph (1) shall not apply to any meeting with respect to which the requirements of the preceding sentence are met."

(b) The amendment made by subsection (a) shall apply to conventions, seminars and meetings beginning after December 31, 1982.

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## I. SUMMARY

Under present law, no deduction is allowed for expenses of attending a convention, seminar, or similar meeting on a cruise ship (Code section 274(h)(2)). The bill provides that business expenses for attending a convention, seminar, or similar meeting on a cruise of a domestic cruise ship will be deductible to the same extent as other business expenses (rather than being subject to disallowance under sec. 274(h)), if certain reporting requirements are satisfied and if all ports of call of the cruise are located within the United States and certain other countries ("the North American area"). The bill will apply to cruise ship seminars and meetings beginning after December 31, 1982.

## II. EXPLANATION OF THE BILL

### *Present Law*

#### *In General*

A deduction is allowed for the ordinary and necessary expenses of carrying on a trade or business or income-producing activity, including transportation expenses and amounts for meals and lodging while away from home in pursuit of a trade or business or income-producing activity. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. Fees charged for admission to a convention or other meeting are generally deductible if there is a sufficient relationship between the taxpayer's trade or business or income-producing activity and attendance at the convention or other meeting. Therefore, generally, a deduction is allowed for the costs of attending a convention or seminar in pursuit of a trade or business or income-producing activity.

Special rules (Code sec. 274(h)) apply to expenses for attendance at conventions, seminars, or similar meetings if held outside the United States, its possessions, Canada, Mexico, or the Trust Territory of the Pacific Islands (the "North American area")[1] or if held on a cruise ship. (Conventions, etc. held outside the North American area are commonly referred to as "foreign conventions".) These rules apply both to the expenses paid by individuals attending such conventions and to expenses paid by employers of such individuals.

No deduction is allowed for the expenses of attending a foreign convention unless the taxpayer establishes that the cost is directly related to the active conduct of a trade or business or income-producing activity and that it is as reasonable to hold the meeting outside the North American area as within it (sec. 274(h)(1)). No deduction is allowed for the expenses of attending any convention held on a cruise ship, including a U.S.-registered cruise ship (sec. 274(h)(2)).

#### *Background of present law*

Special rules for foreign conventions were first enacted in 1976 because of the proliferation of foreign conventions, seminars, and

[1] Under the United States-Jamaican income tax treaty, deductions are permitted for certain expenses of attending a convention in Jamaica (Art. 25(7)).

cruises that were ostensibly held for business or educational purposes, but which appeared to the Congress to be vacations in disguise. Under pre-1976 law, the allowance of deductions for such trips (as for domestic conventions) depended on a subjective determination of the taxpayer's principal purpose in making the trip. This had proved to be a difficult standard for the Internal Revenue Service to apply, particularly in the case of overseas trips.

Under the foreign convention rules as initially enacted in 1976, deductions could be taken for no more than two foreign conventions per year, and were limited to certain transportation and subsistence expenses. Under the 1976 rules, the taxpayer deducting the expenses of attending a foreign convention also had to comply with certain special reporting requirements. For example, the taxpayer had to attach to the income tax return information to indicate the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer had to attach to the income tax return a statement, signed by an appropriate officer of the sponsoring organization, which included a schedule of the business activities of each convention day, the number of hours that the individual attended these activities each day, and any other information required by regulations.

The 1976 rules seemed to be unsatisfactory because those rules in some cases operated to disallow legitimate business travel expenses, but in other cases failed to disallow deductions for trips which actually were foreign vacations (S. Rpt. No. 96–1031, 96th Cong., 2d Sess. 12 (1980)). Accordingly, the Congress revised the rules in 1980 (P.L. 96–608).

The present rule was intended to focus on the reason why a foreign site was selected for the convention or meeting. The disallowance of deductions for expenses of attending conventions on cruise ships was justified on the ground that the personal benefits of going on a cruise often predominate over business purposes. Therefore, it was argued, disallowing deductions for such expenses avoids disputes on audit and prevents taxpayers from claiming deductions that would not be upheld by a court. On the other hand, it was argued that denying deductions for conventions held on all cruise ships (even U.S. flag ships) would disadvantage the U.S. cruise ship industry.

In P.L. 96–608, Congress also repealed the special reporting requirements.

### *Reasons for Change*

The committee believes that the current automatic disallowance of all deductions for cruise ship conventions is overly broad. Since misuse of deductions for convention expenses may occur when a convention is held on land (for example, at a vacation resort, or near a casino or beach) as well as when held on a cruise ship, there is no persuasive justification for singling out U.S. cruise ship conventions for a flat disallowance rule. The current automatic disallowance rule works to the detriment of the U.S. cruise ship industry, without any particular justification for such treatment. The committees believe

that permitting such a deduction for conventions on domestic cruise ships will help that industry and provide jobs for U.S. persons on those ships. The committee believes that enactment of strict reporting requirements to prevent deduction misuse and limitation of cruises to the North American area provide a more appropriate method of treating U.S. cruise ship expenses than the present flat disallowance.

### *Explanation of Provisions*

Under the bill, the expenses of attending a convention, seminar, or similar meeting held on a cruise ship will continue to be disallowed as deductions unless three conditions are met: (1) the cruise ship must be documented under U.S. law, (2) the taxpayer must establish, by satisfying certain reporting and other requirements, that the cruise ship meeting is directly related to the active conduct of the taxpayer's trade or business or to an income-producing activity, and (3) all the ports of call of the cruise must be within the North American area as defined in the Code (the United States, its possessions, the Trust Territory of the Pacific Islands, Canada, and Mexico). A country with which the United States has an income tax treaty that gives a U.S. person a deduction for a business convention held within it is not within the North American area unless the Code so provides. If all these requirements are met, the expenses for attending such a meeting will be deductible to the same extent as expenses of attending a domestic convention held on land.

Under the bill, the taxpayer claiming the cruise ship convention deduction and an officer of the sponsoring organization must sign statements establishing the direct relation of the convention to the taxpayer's business or income-seeking purpose. The bill expressly authorizes the Secretary of the Treasury to prescribe, by regulations, additional requirements which the taxpayer must satisfy in order to establish a direct relationship between the cruise ship meeting and the taxpayer's business or income-producing activities. Such regulations may (but will not necessarily) require information previously required by the 1976 statute described above. The regulations may provide, for example, that the statutory test will not be met unless the required statements are attached by the taxpayer to the taxpayer's return.

Under the bill, as under present law, no deduction is allowed for expenses of attending a convention, seminar, or other meeting held on a cruise ship which is not a U.S.-registered cruise ship. Moreover, no deduction is allowed for expenses of attending a convention or similar meeting held on a cruise ship during a cruise that calls on a port outside the North American area as defined in the Code (sec. 274(h)(3)(A)).

### *Effective Date*

The amendments made by the bill will apply to conventions, seminars, and meetings beginning after December 31, 1982.

## III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

### *Budget Effects*

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 3191, as amended. The committee estimates that the provisions contained in the bill, H.R. 3191, as amended, will have a negligible effect on budget receipts.

The Treasury Department agrees with this statement.

### *Vote of the Committee*

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 3191, as amended, was ordered favorably reported by division vote of 12 to 5.

## IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 3191, as amended.

### *Oversight Findings*

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to application of the rules of the Internal Revenue Code relating to deductions for conventions, seminars, and other meetings that the committee concluded that it is appropriate to enact the provisions contained in the bill.

On March 16, 1982, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means held a hearing on H.R. 3191. On July 12, 1982, that Subcommittee, by voice vote, ordered H.R. 3191 favorably reported to the full committee, with amendments. The Subcommittee transmitted a report to the full committee on September 10, 1982.

### *New Budget Authority and Tax Expenditures*

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

### *Consultation with Congressional Budget Officials on Budget Estimates*

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part III of this report) and submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
*Washington, D.C.*

Hon. DAN ROSTENKOWSKI,
*Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: In accordance with the Budget Act, the Congressional Budget Office has examined H.R. 3191, Tax Deductions for Conventions on Domestic Cruise Ships. This bill provides that business expenses for attending a convention, seminar, or similar meeting on a cruise of a domestic cruise ship will be deductible.

This bill does not provide any new budget authority or any new or increased tax expenditures.

In accordance with Section 403 of the Budget Act, the Congressional Budget Office estimates that the bill will have negligible effect on budget receipts.

Sincerely,

RAYMOND C. SCHEPPACH
(For Alice M. Rivlin, Director).

***Oversight by Committee on Government Operations***

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

***Inflationary Impact***

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

## V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of Rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

## SECTION 274 OF THE INTERNAL REVENUE CODE OF 1954

### SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION.—* * *

* * * * * * *

(h) ATTENDANCE AT CONVENTIONS, ETC.—

(1) IN GENERAL.—In the case of any individual who attends a convention, seminar, or similar meeting which is held outside the

North American area, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting unless the taxpayer establishes that the meeting is directly related to the active conduct of his trade or business or to an activity described in section 212 and that, after taking into account in the manner provided by regulations prescribed by the Secretary—

(A) the purpose of such meeting and the activities taking place at such meeting,

(B) the purposes and activities of the sponsoring organizations or groups,

(C) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organization or groups have been held or will be held, and

(D) such other relevant factors as the taxpayer may present,

it is as reasonable for the meeting to be held outside the North American area as within the North American area.

[(2) CONVENTIONS ON CRUISE SHIPS.—In the case of any individual who attends a convention, seminar, or other meeting which is held on any cruise ship, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting.]

*(2) CONVENTIONS ON CRUISE SHIPS.—In the case of any individual who attends a convention, seminar, or other meeting which is held on any cruise ship, no deduction shall be allowed under section 162 or 212 for expenses allocable to such meeting unless—*

*(A) the cruise ship is a vessel documented under the laws of the United States,*

*(B) all ports of call of the cruise are inside the North American area, and*

*(C) the taxpayer establishes (by written statements signed by the taxpayer and by an officer of the sponsoring organization or group, and by such other methods as may be prescribed by regulations) that the meeting is directly related to the active conduct of his trade or business or to an activity described in section 212.*

*Paragraph (1) shall not apply to any meeting with respect to which the requirements of the preceding sentence are met.*

(3) DEFINITIONS.—For purposes of this subsection—

(A) NORTH AMERICAN AREA.—The term "North American area" means the United States, its possessions, and the Trust Territory of the Pacific Islands, and Canada and Mexico.

(B) CRUISE SHIP.—The term "cruise ship" means any vessel sailing within or without the territorial waters of the United States.

(4) SUBSECTION TO APPLY TO EMPLOYER AS WELL AS TO TRAVELER.—

(A) Except as provided in subparagraph (B), this subsection shall apply to deductions otherwise allowable under section 162 or 212 to any person, whether or not such person is the individual attending the convention, seminar, or similar meeting.

(B) This subsection shall not deny a deduction to any person other than the individual attending the convention, seminar, or similar meeting with respect to any amount paid by such person to or on behalf of such individual if includible in the gross income of such individual. The preceding sentence shall not apply if the amount is required to be included in any information return filed by such person under part III of subchapter A of chapter 61 and is not so included.

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